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THE LAST CHANCE MORTGAGE (A PROPOSAL) BY, JOHN H. VOGEL JR. PERMANENT ADJUNCT PROFESSOR, TUCK SCHOOL OF BUSINESS We are about to experience a tragedy of epic proportions. According to a widely quoted, nationwide review of millions of sub-prime loans by the Center for Responsible Lending, “we project that 2.2 million borrowers will lose their home and up to $164 billion of wealth in the process.” For these families, the American Dream of homeownership is fast becoming a nightmare, and the ripple effect of these foreclosures on neighborhoods will take years to repair. In cities across the country, we are also plagued by a lack of affordable, workforce housing. Study after study shows housing is growing less affordable, even for families with two incomes. For many employers the lack of suitable, affordable housing for their workforce is cited as one of their top three, human resource problems. The question is, can we use the first problem to help solve the second problem? Can we convert housing about to be foreclosed into permanently affordable housing and do it in a cost efficient way that leaves our neighborhoods, lenders, employers and struggling homeowners better off? I believe that we can, and if we do it right, the costs will not fall exclusively on U.S. taxpayers, but will be shared with lenders and distressed borrowers paying a significant part of the cost. A Proposal Our proposal is that we establish a large mortgage pool, which we will call the Last Chance Mortgage Fund, administered by an agency or quasi-public entity like the Federal Housing Administration. Homeowners in danger of foreclosure, would have the option to refinance their mortgage with a special Last Chance Mortgage. If they choose this option, their house would be appraised and a new mortgage would be written at the lesser of either 90% of the appraised value or the outstanding balance on the current mortgage loan. Details are important, but at a conceptual level, let us assume that Last Chance Mortgages would have 30-year amortization schedules and a 3% interest rate. In addition, people who received these

mortgages would need to make monthly payments that included: principle, interest, insurance, property taxes and a 1% reserve. The reserve would ensure that the house would continue to be well maintained, as we will explain later. The homeowner receiving a Last Chance Mortgage gets to stay in their house and build up savings as they pay down their mortgage. But they would lose all the equity in their home and the opportunity to sell their house for more than the amount of the initial mortgage. The tradeoff is that they get the stability of homeownership and monthly payments they can afford, but give up the opportunity for appreciation. It is also important to try to keep things as simple as possible. Let me use an example based on the following assumptions: • Our distressed homeowners have a 30 year, sub-prime or adjustable rate loan for $250,000 at a 10% interest rate. • Their house currently has an appraised value of $200,000. • Property taxes and insurance average $700 per month. In this scenario, our family is currently paying approximately $2,894 per month on the mortgage, including escrows for property taxes and insurance. If this family decides to switch to the Last Chance Mortgage, the first thing that happens is that their mortgage drops to $180,000 (90% of the appraised value of the house). Coupled with the reduced interest rate, their monthly payment drops to $1,609 per month, which includes the 1% (or $1,800 per year) reserve. Hopefully, at this lower payment, the family can afford to stay in their home. The 1% reserve is designed to ensure that the house continues to be well maintained. Like the property tax payment, this $1800 would go into an escrow account, which the homeowner could only pull out for defined capital repairs like fixing the roof or replacing an appliance. Even though the homeowner would not benefit from appreciation in the value of their home, they would still have a strong incentive to use this reserve to make the house as comfortable and livable as possible. In addition, if the person lived in the house for 30 years and paid off the mortgage, they would be entitled to receive $180,000 from the FHA when they sold the house, as long as it was in satisfactory condition. Under normal circumstances, would most people choose a Last Chance Mortgage? Probably not. But if the choice is take this mortgage or lose your home, this mortgage would be attractive and might allow a family to get through some rough times until they saved enough to move to another house where they could enjoy all the benefits of homeownership, including the chance for appreciation. And when they left, we would have a house that would be affordable for some other family that could not afford market rate housing. In other words, we would have an inventory of permanently affordable housing for working people. The Lenders What about the lenders? Would they be willing to go along with this arrangement? I am confident that they would. In the example cited above, the lender would receive $180,000 in cash as payment for their mortgage. The transaction would be quick, simple and require very little work on the lenders' part. For the lender, the alternative to the Last Chance Mortgage program would be to foreclose on the house. This process could take months, and in the meantime the family living in the house would have very little incentive to maintain it. Then the lender would need to hire a broker or auctioneer to sell the house and might have to settle for a firesale price well below the $200,000 at which it was appraised. Between the legal fees, the brokerage fees and all the other expenses the lender would be lucky to net $180,000, to say nothing of the time and hassle involved. Finally, most lenders do not like to foreclose on properties and kick people out of their homes. In fact, once the program was worked out with key lenders, I suspect that they would help to market it to potential homeowners. Most lenders would be pleased to be able to say to homeowners "here is a way out of your problems". Most residential lenders understand that a certain number of loans do not work and are interested in resolving the situation quickly, so that they can move on to other things. Our Better Selves How did we get in this mess? Clearly some lenders and mortgage brokers sold homeowners a product they could not afford. Some homeowners were greedy. And some homeowners felt that with the rapidly increasing cost of housing, they needed to take a risk and buy now or they might never be able to afford a home. The problem is that if we focus on motives and punishments, we will not come up with a solution. Instead, we need to focus on helping people stay in their homes and building an inventory of permanently affordable housing. Not every house will qualify for a Last Chance Mortgage, nor will every homeowner. It will be challenging to develop an appropriate set of rules and guidelines. But if creatively designed and intelligently administered, the Last Chance Mortgage Fund might be a powerful tool in combating massive foreclosures. Since the government's cost of borrowing is more than 3%, there will be a cost for this program. There will also be a cost for administering both the initial mortgage loans and the ongoing oversight and administration. But if we use the government's current borrowing costs for 30 year bonds at 4.75% and assume that it will cost another 0.25% to administer the program, then the subsidy cost for the house in our example would be about $218 per month. By contrast, the monthly cost under the section 8 program for housing a family in a two bedroom apartment in Boston is currently $1343 per month of which the government typically pays at least 50%, and this calculation does not include the cost of administering the section 8 program. Similarly, compared to the expense of building new, affordable housing, the houses acquired through the Last Chance Mortgage program will be a bargain. There are lots of details to be worked out. The most efficient program would be national in scope, but it could also work at the state or even city level. The time has come to act boldly. If we can save a large number of families from foreclosure, save neighborhoods from empty, deteriorating houses and begin to address the lack of affordable housing in this country, we might turn a potential tragedy into something positive.